Politics *or* Sound Business?

The industry debates a cattle futures contract change.

*by **Barb Baylor Anderson***

The board of directors of the Chicago Mercantile Exchange (CME) voted in fall 2002 to reduce spot-month speculative limits on the live-cattle futures contract from 600 contracts to 300 contracts. Whether the reduction will have any impact on the price of cattle in Kansas, or elsewhere, is anyone's guess. But one thing is certain. Everyone has an opinion about the change.

Prior to December 2001, a speculative position holder was allowed no more than 3,300 live-cattle futures contracts per contract month. The holder had to "scale down" spot, or current month, positions to 600 contracts by the close of business on the first business day following the first Friday of the contract month. A 300-contract limit then took effect at the close of business on the business day immediately before the last five business days of that month. The last trading day is the last business day of the contract month.

Beginning with the December 2002 contract month, the new speculative position limit in the spot month eliminated the scale-down limit of 600 contracts. Position holders instead are now required to reduce to 300 contracts at the close of business on the first business day following the first Friday of the contract month. That day coincides with the first day that delivery notices are issued.

Sound business?

The revision was approved by the Commodity Futures Trading Commission (CFTC) in November, and covers the live-cattle futures contract months through October 2003. In asking for the change, the CME argued that the revision helps balance the contract with deliverable live-cattle supplies.

The National Cattlemen's Beef Association (NCBA) says the change is consistent with its longstanding policy to limit speculator activity during the delivery month.

"Over the past few years, we have consistently made requests for such a decision. These limits will reduce downward bias on the market and risk of undue influence of large traders during the delivery period," says Bryan Dierlam, NCBA director of legislative affairs.

NCBA has long contended that futures contract rules and specifications should prevent manipulation and pricing distortion risks. In addition, NCBA supports contract specifications consistent with current industry conditions and reflective of the existing cattle population.

"The delivery process must be as frictionless as possible to avoid needless costs, discounts, disruptions and surprises that would discriminate against delivering or receiving parties. Speculative limits must be established at levels that are not disproportionate to available deliverable supply so that risk of price distortions and market manipulation is diminished. When speculative limits exceed available deliverable supply and there is risk of manipulation, the market does not effectively manage risk, ensure basis convergence or serve an adequate price discovery function," NCBA noted in its CFTC comments.

Or not?

Not every industry group shares that opinion. The Committee for Equitable Cattle Pricing, in an open letter to the cattle industry last October, stated, "Anyone who is at all familiar with the cattle industry recognizes the heavy influence that futures prices have over live-cattle prices, particularly in the delivery month. … Only hedgers, packers and chain stores want futures to liquidate on weakness. The vast majority want futures to liquidate on strength. … Cutting in half the speculative limits as the spot month nears expiration will pressure cattle prices. …"

The Nebraska Cattlemen's Association has a similar opinion.

"The change forces speculative longs from the marketplace at an increased pace in the spot month, and the liquidation of long positions will provide a downward bias in the spot contract leading into the delivery time frame," asserts Dave Burkholder, the organization's president.

Burkholder contends the change will hold potential negative consequences for both those who use the contract as a hedging mechanism and the vast majority of cattle producers who do not use the futures market to transfer risk at all. He says the problem is that cash fed-cattle trade has become thinner and less transparent in recent years as the number of cattle marketed on noncash mechanisms increases. As a result, the futures market has become an integral part of the price discovery process.

"We could see a reduction in liquidity in the spot contract and a more volatile environment in which to cover hedge positions as cattle are sold," he explains. "Sufficient speculative long participation in the market is absolutely essential for producers to be able to efficiently lay off risk in the futures market."

The Ranchers-Cattlemen Action Legal Fund, United Stockgrowers of America (R-CALF USA) told the CFTC that the change would create a market bias strongly favoring the large short hedgers in the cattle futures market, which they agree has potential to have a negative impact on prices.

"We believe the CME has grossly erred in its identification of the problem … what appears to be a distortion of the futures market is in reality a distortion of the cash market," says R-CALF USA president Leo McDonnell. "The amendment will effectively invalidate the 'bear' raids of retailers. The losers are the sellers of unhedged cattle and calves."

R-CALF USA requested the CME not be allowed to increase contract delivery weights beyond existing specifications, a point that remains under review. The group's argument is that producers delivering cattle at weights above current specifications are subject to severe discounts under existing marketing terms.

The CME will reportedly propose changes to deliverable weights and spot position limits for December 2003 and subsequent contract months to address deliverable supply concerns on the contract. The CME had not released any information to that effect as of press time.

However, in asking for the change in speculative limits, the CME stated that the deliverable supplies of live cattle meeting the futures contract's existing weight specifications have been "adversely impacted by a significant increase in U.S. cattle slaughter weights. A growing proportion of cattle are rapidly becoming ineligible for delivery against the live cattle contract."

Currently, the futures contract does not permit the delivery on a live-graded basis of individual steers weighing more than 1,350 pounds (lb.). That figure increases to 1,375 lb. effective with the June 2003 contract month. For reference, the average carcass weight for steers has increased steadily in recent years. In August 2002, the carcass weight was the live equivalent of 1,329 lb.

Protect your interests

Producers have several options in addressing the debate, including protecting profitability through proactive marketing strategies and supporting or challenging changes in the live-cattle futures contract down the road.

While the impact of the change to the December 2002 contract month value was unknown as of press time, market analysts note that cattle prices were near historic favorable levels, despite long liquidation in the market.

"With prices having risen more than $5 over the last quarter of the year, speculators and commodity pool funds were taking profits or rolling positions forward into other contract months before they had to reduce their positions," says Mike Zuzolo, Risk Management Commodities Inc., Lafayette, Ind. "The Commitment of Traders report showed that noncommercial market participants made up about 39% of the long position holders in live-cattle futures contracts, which appears to be normal, although they were quickly getting out of long positions."

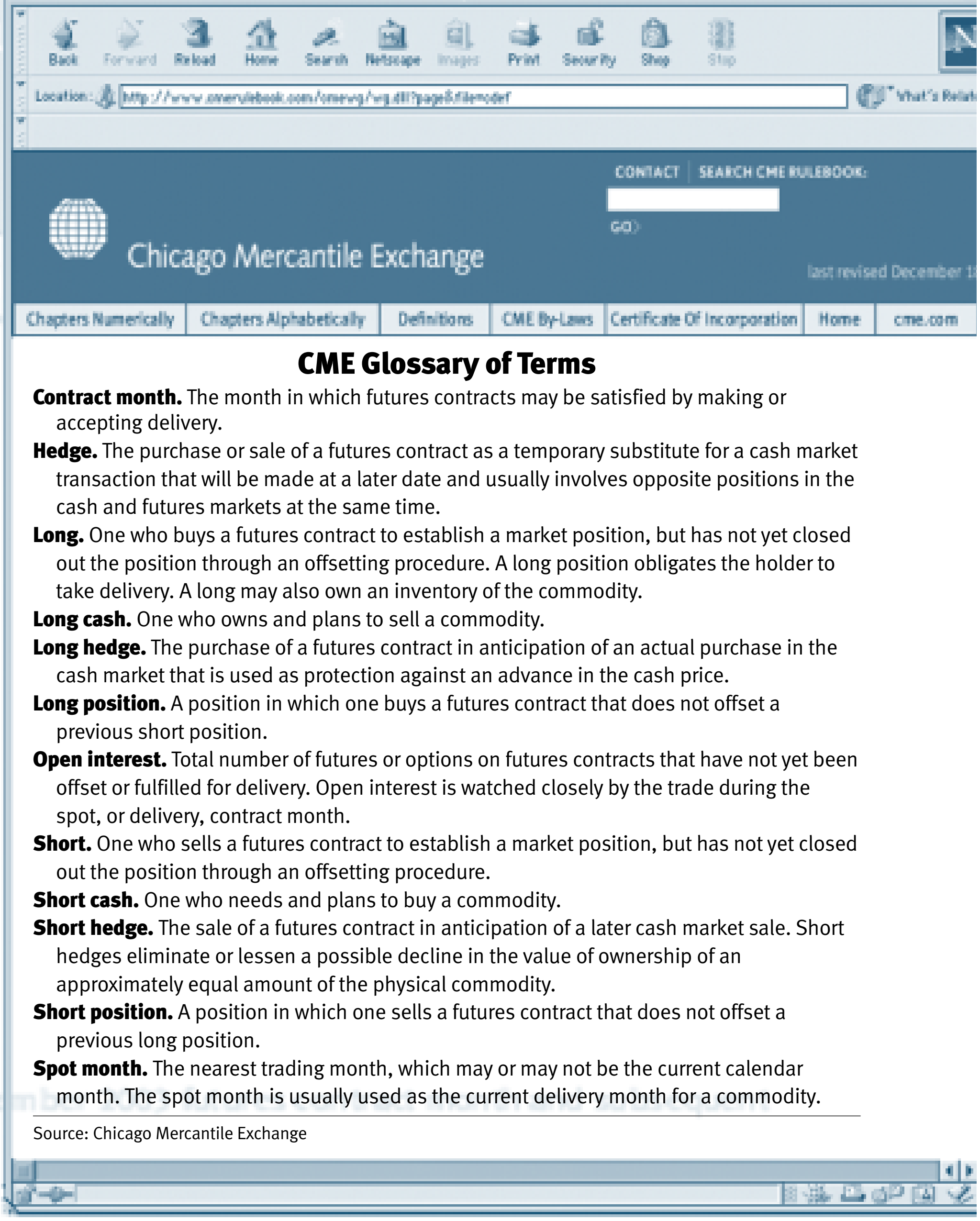
Despite the spot month pressure from long liquidation, Zuzolo predicts market fundamentals, such as any adverse weather, weights and slaughter levels, should continue to have a positive influence on the market in early 2003.

"Fund traders, or speculators, do not want to take physical delivery of cattle, so they will get out of the market. That may burden cash prices," he says. "But at the same time, if you look at the price of live cattle in the upper $70s, producers should price cattle so they do not have to worry about spot-month values. The 25-year charts show you that any time fed cattle approach $80, even with high-priced corn, you really can't lose."

Roger Norem, AgriVisor Services, Bloomington, Ill., also encourages producers to consider hedging protection. "Producers should take advantage of current market levels and hedge marketings from April forward," he says. "The CME's move is not unprecedented for mature, commodity contracts on a 'bull' run. And while the larger open interest could create more volatility to the downside, you can look for opportunities to lock in profitability."

The Committee for Equitable Cattle Pricing offers longer-term suggestions for addressing live-cattle futures needs that may benefit producers. "There is a small army working on live price setting problems," their October open letter states. "In the meantime, there are several things that can be done to address futures price problems."

The group advocates restructuring the live-cattle futures contract to represent a balance of industry interests, assuring that market shorts and longs have absolutely equal rights to a level playing field; listing a delivery contract for every month rather than every other month; weighing the interests of longs rolling positions forward side-by-side with interests of hedgers lifting hedges; and confirming that under no conditions should the futures contract permit delivery of undesirable cattle.



CME Glossary of Terms

Contract month. The month in which futures contracts may be satisfied by making or accepting delivery.

Hedge. The purchase or sale of a futures contract as a temporary substitute for a cash market transaction that will be made at a later date and usually involves opposite positions in the cash and futures markets at the same time.

Long. One who buys a futures contract to establish a market position, but has not yet closed out the position through an offsetting procedure. A long position obligates the holder to take delivery. A long may also own an inventory of the commodity.

Long cash. One who owns and plans to sell a commodity.

Long hedge. The purchase of a futures contract in anticipation of an actual purchase in the cash market that is used as protection against an advance in the cash price.

Long position. A position in which one buys a futures contract that does not offset a previous short position.

Open interest. Total number of futures or options on futures contracts that have not yet been offset or fulfilled for delivery. Open interest is watched closely by the trade during the spot, or delivery, contract month.

Short. One who sells a futures contract to establish a market position, but has not yet closed out the position through an offsetting procedure.

Short cash. One who needs and plans to buy a commodity.

Short hedge. The sale of a futures contract in anticipation of a later cash market sale. Short hedges eliminate or lessen a possible decline in the value of ownership of an approximately equal amount of the physical commodity.

Short position. A position in which one sells a futures contract that does not offset a previous long position.

Spot month. The nearest trading month, which may or may not be the current calendar month. The spot month is usually used as the current delivery month for a commodity.

Source: Chicago Mercantile Exchange

Editor's Note: *To find out more about the Chicago Mercantile Exchange and futures market fundamentals, visit the CME Web site at* www.cme.com. *For basic information on using futures and options, click the Getting Started button. To get to information on live-cattle contracts, insert "live cattle" (including the quotation marks) in the search field and click go.*